

Letter of Findings: 02-20170885
Corporate Income Tax
For the Years 2013, 2014, and 2015

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HOLDING

Indiana Manufacturer failed to establish that it was entitled to claim Indiana's research expense credit; in reviewing activities which involved the development and manufacture of its metal products, the Department found that Manufacturer did not undertake a process of experimentation which qualified it for the credits and did not create, retain, and provide the requisite contemporaneous documentation justifying its claim to the credits.

ISSUE

I. Corporate Income Tax - Qualified Research Expense Projects and Documentation.

Authority: IC § 6-3-1-3.5(b); IC § 6-3.1-4-1; IC § 6-3.1-4-2(a); IC § 6-8.1-5-1(c); IC § 6-8.1-5-4; IC § 6-8.1-5-4(a); *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); *Trinity Industries, Inc. v. U.S.*, 757 F.3d 400 (5th Cir. 2014); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Union Carbide Corp. and Subsidiaries, v. C.I.R.*, 97 T.C.M. 1207 (2009); I.R.C. § 41(d); I.R.C. § 41(d)(1); I.R.C. § 41(d)(1)(A); I.R.C. § 41(d)(1)(B)(i); I.R.C. § 41(d)(1)(B)(ii); I.R.C. § 41(d)(1)(C); I.R.C. § 41(d)(2); I.R.C. § 6001; Treas. Reg. 1.41-4 (T.D. 9104); Treas. Reg. § 1.41-4(a)(3); Treas. Reg. § 1.41-4(a)(3)(i); Treas. Reg. § 1.41-4(a)(3)(ii); Treas. Reg. § 1.41-4(a)(5); Treas. Reg. § 1.41-4(d); Treas. Reg. § 1.6001-1; Treas. Reg. § 1.174-2; Treas. Reg. § 1.174-2(a); Letter of Findings 01-20180753 (June 15, 2018); Letter of Findings 01-20171187; 01-20171188; 01-20171189; 01-20171190 (May 1, 2018); Letter of Findings 01-20170279; 01-20170288 (October 6, 2017); Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017); Letter of Findings 01-20150385 (December 6, 2016); Letter of Findings 02-20130676 (January 16, 2015); Letter of Findings 02-20140326 (October 30, 2015); Letter of Findings 01-20110213 (October 4, 2011).

Taxpayer argues that it conducted qualified, experimental research activities, that it can adequately document the wage and supply expenses related to those projects, and that it is now entitled to claim the benefit of credits associated with the qualifying activities.

STATEMENT OF FACTS

Taxpayer is an Indiana manufacturer of metal products specializing in "high tolerance" metal products and machine tooling. Taxpayer sells its products to medical and surgical equipment suppliers, aerospace companies, automobile manufacturers, and other industrial customers. Taxpayer sells its customers such items as automobile pistons, fuel injectors, jet engine parts, and medical equipment such as surgical chisels, reamers, and artificial knee components.

Taxpayer engaged a consulting firm to review its 2013, 2014, and 2015 business activities and prepare a "research and expense study." In the final research credit study report, the consulting firm concluded that Taxpayer conducted qualified research activities entitling it to claim Indiana labor and supply tax credits.

Taxpayer determined that it incurred approximately \$12,000,000 in qualified research wage and supply expenses entitling it to claim approximately \$740,000 in research and expense credits on its 2013, 2014, and 2015 corporate income tax returns.

The Indiana Department of Revenue ("Department") thereafter conducted a corporate income tax audit of Taxpayer. The Department's audit reviewed Taxpayer's tax returns, business records, and manufacturing records.

On the ground that Taxpayer was not entitled to the claimed wage and supply expense credits, the Department denied all the Taxpayer's originally claimed credits and assessed additional corporate income tax. The audit did so because it found that Taxpayer's activities did not meet the statutory and regulatory definition of "qualified research." The audit also concluded that Taxpayer was unable to verify the amount of time during which Taxpayer's employees were purportedly engaged in activities which met the definition of "qualified research."

Taxpayer disagreed with both the Department's decision disallowing the credits and resultant tax assessment. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Corporate Income Tax - Qualified Research Expense Projects and Documentation.

DISCUSSION

The issue is whether Taxpayer conducted qualifying research activities in developing and improving its metal products, whether Taxpayer can adequately document the extent to which it conducted that experimental research, and whether Taxpayer can adequately document the wage and supply expenses related to these activities.

A. Department's Audit Examination.

1. Qualifying Research Projects.

During the years 2013, 2014 and 2015, Taxpayer claimed it incurred approximately \$12,000,000 in qualifying research expenses ("QREs") entitling it to approximately \$740,000 in Indiana Research Expense Tax Credits ("RECs"). Those expenses were attributable to wage and supply costs.

The Department's audit concluded that the Taxpayer's development and production of its metal products did not "overcome the 4-part test" required under I.R.C. § 41(d) which defines "qualified research" as research:

1. [W]ith respect to which expenditures may be treated as an expense under section 174[;]
2. [W]hich is undertaken for the purposes of *discovering information* which is technological in nature (also known as the Discovery Test)[;] and
3. [T]he application of which is intended to be useful in the development of a *new or improved business component* of the taxpayer; and
4. [S]ubstantially all of the activities which constitute elements of a process of experimentation for a [qualified purpose.]

(*Emphasis added*).

At the outset, the Department's audit found that Taxpayer had erroneously based its claim to the credits on the application of "TD 9104 in calculating its Indiana research expense credit on its Indiana income tax returns." According to the audit report:

The regulations that the [T]axpayer has asserted that it has relied on to calculate its credits were not promulgated and in effect until well over eleven months after the statutorily prescribed income in IC [§] 6-3.1-4-4.

The Department's audit reviewed information contained within the research study in addition to information provided by Taxpayer such as control and measurement plans.

The audit concluded that Taxpayer failed to establish that it qualified for the credits because Taxpayer's cited activities did not meet the four-part test set out in I.R.C. § 41(d).

(a) Research Expenditures.

The audit found that Taxpayer's expenditures did not meet the first test - verifying qualified research and experimental expenditures - based on the definition set out in Treas. Reg. § 1.174-2(a). The audit found that there

was no information establishing that it incurred costs "that pertain to eliminating uncertainty concerning product development" Instead, "[T]axpayer would simply appear to be completing contracts in which they adapt existing business components to meet specific customer specifications." The audit found that the claimed expenses were incurred "simply doing what is required to be done in the normal practice of this industry [and that] these costs are ordinary and necessary business expenses" As explained in the audit report:

When a taxpayer is performing normal business activities for which they are well qualified to solve the problems presented by the contract requirements, the uncertainty of the results of the contract are primarily of a monetary nature and involve economic risk rather than technical risk.

As to the first of the four part test, the audit concluded that "[T]axpayer did not provide evidence that the activities were conceptually new or that they went beyond doing what was considered normal practice of this industry" and that "[a] technical activity having no or very little uncertainty in capability or method is considered a non-qualifying activity for REC purposes."

(b) Discovering Technological Information.

The audit found that Taxpayer failed the second test as set out in Treas. Reg. § 1.41-4(a)(3) (2001) which requires that research "must be undertaken for the purpose of discovering information that is technological in nature." As explained in Treas. Reg. § 1.41-4(a)(3)(i), "Research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals"

The audit relied on Treas. Reg. § 1.41-4(a)(3)(ii) (2001) for the definition of "common knowledge."

Common knowledge of skilled professionals in a particular field of science or engineering means information that should be known to skilled professionals had they performed, before the research in question is undertaken, a reasonable investigation of the existing level of information in the particular field of science or engineering.

The audit report again noted that Taxpayer had been in the business of developing metal products for "many years and has several long time employees with education and experience in the [Computerized Numerical Control] manufacturing industry." Taxpayer failed to establish that it was discovering information that was technological in nature and which built upon and expanded the foundational knowledge of other experienced skilled professionals in the manufacturing business. In sum, Taxpayer failed "to explain what type of experimentation actually occurred on the various projects"

(c) New or Improved Business Component.

The audit found that Taxpayer failed to meet the third, "business component," test. According to the audit report, "A business component is defined as any product, process, computer software, technique, formula or invention to be held for sale, lease, or license and used by the taxpayer in a trade or business of the taxpayer." According to the audit report, Taxpayer and Taxpayer's expense study failed to establish that it conducted an analysis of each separable and unique business component.

According to the audit report, Taxpayer's metallurgical activity was not "tied" to any particular Taxpayer business component because Taxpayer had not prepared and provided contemporaneous information to tie the projects/business components to the claimed wage and supply expenses. According to the audit report, Taxpayer failed to meet the Treas. Reg. 1.41-4(d) "contemporaneous record" requirement which requires:

A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.

As summarized in the audit report, "[T]axpayer did not utilize a project accounting system and could not supply documentation to support research wages by research project [and] could not substantiate the qualified research expenses to the relevant business component"

(d) Undertaking a Process of Experimentation.

The audit found that Taxpayer failed to meet the fourth, "process of experimentation" test as defined under Treas. Reg. § 1.41-4(a)(5) (2001). The regulation states:

A process of experimentation is a process to evaluate more than one alternative designed to achieve a result where the capability or method of achieving that result is uncertain at the outset. A process of experimentation does not include the evaluation of alternatives to establish the appropriate design of a business component, if the capability and method for developing or improving the business component are not uncertain

The audit found that Taxpayer's activities missed the experimentation benchmark because simple "uncertainty" was not sufficient and because Taxpayer "had not provided records by business component or that the 'substantially all' requirement was met for each business component." The audit concluded that "[s]ufficient evidence has not been provided to explain what type of experimentation actually occurred on the various [claimed] projects.

Anticipating Taxpayer's objection as to which regulatory regime was relevant in determining Taxpayer's qualification for the credit, the audit report found that under either regulatory regime, Taxpayer's development and production of metal products did not rise to the level of "qualified research." Whether under Treasury Decision 8930 (T.D. 8930, 66 F.R. 280-01), 2001 WL 34028585 (eff. Jan. 3, 2001) incorporating the "discovery test" or under Treasury Decision 9104 (T.D. 9104, 69 F.R. 22-01, 2004 WL 18938) (eff. Jan. 2, 2004) incorporating the less rigorous "uncertainty test," the audit concluded - as noted above - that Taxpayer had not established it was undertaking a "process of experimentation" qualifying it for the credits.

In general and in support of the proposition that Taxpayer would have failed to meet the "process of experimentation" standard under the TD 9104 uncertainty standard, the audit cited to Treas. Reg. 1.41-4 (T.D. 9104) which provides in small part:

Uncertainty concerning the development or improvement of the business component (e.g. its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.

2. Wage and Supply Expense Documentation.

The Department's audit concluded that Taxpayer did not prepare and retain contemporaneous records at the outset of its projects necessary to substantiate Taxpayer's argument that it was entitled to credits based on wages paid to Taxpayer's employees or the cost of supplies consumed in developing or manufacturing its metal products. The audit report stated that Taxpayer claimed credits based upon the consultant's after-the-fact employee interviews and questionnaires.

The [REC Study] completed by [consulting company] states the employee qualified research participating percentages were estimated based on manager interviews.

The audit rejected the consultant's and Taxpayer's reliance on employee interviews and reliance on "estimates." As explained in the audit report, "Wage expenses claimed were estimated based on employee questionnaires which were completed at the end of each year." The estimates were developed by means of a "percentage for an overall annual time allocation" but were "not completed during the research process." The audit report explains:

The explanation from [consulting company] of how each employee's qualified research participation percentage was calculated is in direct conflict with [Treas. Reg. § 1.41-4(d) (TD 8930)].

Treas. Reg. § 1.41-4(d) (TD 8930) sets out the record keeping and documentation requirements for expenses related to the research credit.

No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer - (1) *Prepares documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section, and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed (except under section 6501(c)(1), (2), or (3)) for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) Satisfies section 6001 and regulations thereunder.*

(Emphasis added).

As to Taxpayer's record keeping responsibility under Indiana law, the audit cited to this state's own statutory record keeping requirement found at IC § 6-8.1-5-4(a) which provides:

Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts and canceled checks.

Under the final regulations, a taxpayer must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. See I.R.C. § 6001; Treas. Reg. § 1.6001-1. The taxpayer must clearly establish full compliance with all of the relevant statutory and regulatory requirements. Failure to maintain records in accordance with these rules is a basis for disallowing the credit.

The Department concluded that even if Taxpayer had conducted qualifying research activities, Taxpayer had not prepared, maintained, retained, or presented records necessary to document that qualifying research. As stated in the audit report:

[T]he regulations contained in Treasury Decision 8930, promulgated and in effect on January 1, 2001, state that [a] taxpayer must have contemporaneous documentation that was prepared before or in the early stages of the research project that describes the principal questions to be answered and the information the taxpayer seeks to obtain.

B. Taxpayer's Response.

1. Qualifying Research Projects.

Taxpayer disagrees with the Department's conclusion that it does not engage in qualifying research activities. Taxpayer explains that it undertakes "process experiments involv[ing] a complex process involving metallurgical science" These experiments examine "the physical and chemical behavior of metallic elements and their mixtures called alloys."

Taxpayer disagrees with the audit's conclusion that its activities failed to meet the first of the four-part test set out in Treas. Reg. § 1.174-2. Taxpayer states that the issues it addressed could not have been resolved by tapping into its institutional knowledge. Instead, Taxpayer argues that it addressed "uncertainties" in producing its metal products.

Here at the outset of each project, [Taxpayer] encountered various uncertainties, including those with respect to optimal final design of the product, the optimal method by which to produce such product, and the capability to design and build such products to meet client specifications.

As an example, Taxpayer cites to a project under which it developed jet aircraft "compressor stators." According to Taxpayer, it had never manufactured these aircraft parts, was unfamiliar with the production method, that the production of stator prototypes required the development of special tools, and the final production process "was [only] determined through trial and error."

Taxpayer disagrees with the audit's conclusion that its activities failed to meet the third test - development of "technological information" - because the Department's audit utilized the wrong standard. Taxpayer explains that it was entitled to rely on the "uncertainty" test and was not required to "discover" information which advanced the knowledge of other skilled metal product manufacturers. Taxpayer states that the Department's audit:

[I]gnores the fact that, at the outset of its projects, [Taxpayer] was uncertain as the appropriate design of such manufacturing process even though [the] fact a properly-designed process could produce a commercially viable product may have been likely. The relevant uncertainty is that of design, not outcome . . .

Taxpayer also disagrees with the audit's conclusion that its activities failed to meet the second, Treas. Reg. § 1.174-2., test because it provided evidence establishing that its employees' activities were "useful in the development of a new or improved business component." Taxpayer fundamentally disagrees with the notion that it was ever required to provide the audit with "contemporaneous" documentation. Instead, Taxpayer states that it was sufficient to "retain records in a sufficiently usable form and detail to substantiate the expenditures claimed

are eligible for the credit." Taxpayer concludes that its employee surveys, work summaries, and employee testimony should have been sufficient to corroborate its estimated wage and supply expenses.

Finally, Taxpayer disagrees with the audit's conclusion that it failed to establish that Taxpayer engaged in a process of experimentation. Taxpayer states that the relevant regulations do not define the phrase, "process of experimentation." However, Taxpayer contends that "experimentation" simply requires the process of evaluating "more than one alternative" and a "continuous development of hypotheses." According to Taxpayer, "[m]odeling, simulation, or trial and error are [all] acceptable forms of experimentation." In support of its proposition, Taxpayer again cites to its development of the jet engine stators noting that production of the compressor stators involved the production of "over 100 different prototypes in its effort to determine the best method for producing the stators."

In developing the process by which it finally developed the means to manufacture the compressor stators, it found that initially the required tooling was faulty. The faulty tooling "was too slow and [] too cumbersome to use." Taxpayer was required to scrap the tooling and spend time developing new tooling.

2. Wage Expense Documentation.

Taxpayer disagrees with the Department's conclusion that Taxpayer failed to adequately document its employees' research activities and the supply expenses associated with those qualifying activities. Taxpayer maintains that the Department erroneously relied on the "contemporaneous" standard and it was merely required to provide "records in a sufficiently usable form and detail . . ." as set out in Treas. Reg. § 1.41-4(d). Taxpayer also finds fault with the audit's reliance on IC § 6-8.1-5-4 because under Indiana law taxpayers should not be penalized for lacking records and because Indiana law does not "preclude them from submitting estimates if they lack contemporaneous records."

C. Burden of Proof, Analysis, and Conclusion.

1. Proving that Taxpayer is Entitled to the Credit.

Tax assessments are *prima facie* evidence that the Department's assessment of tax is presumed correct; in every assessment case, each taxpayer bears the burden of proving that the assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-3.1-4-1 provides that, "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under [IC 6-3](#)." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000).

Every taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. Indiana and federal law require that a taxpayer maintain and produce contemporaneous records sufficient to verify those credits. See Treas. Reg. § 1.41-4(d). (See also IC § 6-8.1-5-4(a) which requires that taxpayers *keep* records). Where such a credit is claimed "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)).

Citing *Stinson Estate*, the circuit court in *United States v. McFerrin* summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009). See also *New Colonial Ice Co. v. Helvering*, 292 US. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.")

2. The Research Expense Credit's Regulatory Regime.

At the outset, the Department rejects Taxpayer's argument that neither TD 8930 nor TD 9104 were the governing regulatory scheme relevant to the years at issue. Taxpayer's argument is that a pre-regulatory REC standard governs Taxpayer's protest. The Department has addressed and repeatedly rejected this basic, foundational issue. The Department has time-after-time staked out its position in detail which need not be repeated here. See Letter of Findings 01-20180753 (June 15, 2018) 20180829 Ind. Reg. 045180334NRA, Letter of Findings 01-20171187; 01-20171188; 01-20171189; 01-20171190 (May 1, 2018); 20180725 Ind. Reg. 045180286NRA;

Letter of Findings 01-20170279; 01-20170288 (October 6, 2017) 20180131 Ind. Reg. 045180014NRA; Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017), 20170830 Ind. Reg. 045170363NRA; Letter of Findings 01-20150385 (December 6, 2016), 20170222 Ind. Reg. 045170090NRA; Letter of Findings 02-20130676 (January 16, 2015), 20150325 Ind. Reg. 045150065NRA; Letter of Findings 02-20140326 (October 30, 2015), 20151230 Ind. Reg. 045150436NRA; Letter of Findings 01-20110213 (October 4, 2011), 20111228 Ind. Reg. 045110749NRA.

The Department has repeatedly, consistently, and clearly staked out its position on this matter. The Department has historically applied the 2001 final regulations, published under T.D. 8930 (the "2001 Final Regulations"). The 2001 Final Regulations define qualified research and development under I.R.C. § 41 to include a "discovery requirement." Simply stated, the REC requires that the taxpayer undertake activities "for the purposes of *discovering information* which is technological in nature." I.R.C. § 41(d)(1).

3. Indiana's Research and Expense Tax Credit.

For income tax purposes, Indiana follows the federal tax scheme with certain state-specific modifications. IC § 6-3-1-3.5(b). Indiana provides tax credits outlined in [IC 6-3.1](#) which a taxpayer may claim to reduce its taxable income. One of the tax credits is the "Indiana qualified research expense" tax credit under IC § 6-3.1-4-2(a), which states that, "A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year." IC § 6-3.1-4-1 defines the credit. In part, this statute - in effect for the taxable years in question - provides:

"Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana. "Qualified research expense" means qualified research expense (**as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001**). (**Emphasis added**).

Further, "qualified research expense" under the 2003 Indiana Statute is "as defined in Section 41(b) of the Internal Revenue Code **as in effect on January 1, 2001**[]" IC § 6-3.1-4-1 (2003) (**Emphasis added**). "Qualified research" is defined in the Internal Revenue Code ("I.R.C.") under section 41(d) I.R.C. subsection 41(d) defines qualified research in pertinent part as follows:

- (d) Qualified research defined.-For purposes of this section-
 - (1) In general.-The term "qualified research" means research-
 - (A) with respect to which expenditures may be treated as expenses under section 174,
 - (B) which is undertaken for the purpose of discovering information-
 - (i) which is technological in nature, and
 - (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
 - (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph . . .

I.R.C. § 41(d)(1).

This provision sets out the four-pronged test for determining whether a taxpayer conducted qualified research. First, the research must have qualified as a business deduction under § 174. *See Id.* § 41(d)(1)(A). Second, the research must be undertaken to "discover information which is technological in nature." *Id.* § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. *Id.* § 41(d)(1)(B)(ii). Finally, the taxpayer must undertake a "process of experimentation" during substantially all of the research. *Id.* § 41(d)(1)(C).

4. Analysis and Conclusions.

In order for its argument to prevail, Taxpayer's activities must meet the four-part test under I.R.C. § 41(d) including the requirement that Taxpayer's activities were undertaken for the "purposes of discovering information" and must eventually yield a "new or improved business component" each of which derives from a process of experimentation.

As explained by Taxpayer, its "business components" consist of such items as the jet engine compressor stators developed for one of its customers. Although the Department neither minimizes nor dismisses the difficulty in manufacturing such sophisticated components, Taxpayer has not established that it fundamentally expanded upon the "common knowledge" or the expertise shared by other skilled metal manufacturers using variations of

long-standing techniques, or expanded the "existing level of information in [Taxpayer's] field of science or engineering." Treas. Reg. § 1.41-4(a)(3)(ii).

Taxpayer states that it carefully and methodically develops its metal products, but Taxpayer has not conclusively established that its development process does more than reflect a knowledgeable and detailed process of "trial and error" aimed at improving or differentiating its products. Taxpayer studies, investigates, develops prototypes, fails, fails again, and then typically succeeds in meeting its clients' expectation. However, Taxpayer's process - even if it did lead to the "discovery" of a new product - does not represent "a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis so that it constitutes experimentation in the scientific sense." *Trinity Industries, Inc. v. U.S.*, 757 F.3d 400, 414 (5th Cir. 2014). As explained by that court, the "process of experimentation" requirement is not met by means of "a method of simple trial and error to validate that a process or product change meets the taxpayer's needs." *Id.* (See also *Union Carbine Corp. and Subsidiaries v. C.I.R.* 97 T.C.M. (CCH) 1207 (Tax Ct. 2009) explaining "It is not sufficient that the taxpayer use a method of simple trial and error to validate that a process or product change meets the taxpayer's needs.")

The Department is unable to agree that Taxpayer has met its statutory burden under IC § 6-8.1-5-1(c) of establishing that the Taxpayer's activities to improve upon its business components constitute "qualified research" activities under either the "Discovery Test" or the "Uncertainty Test." Simply demonstrating the "uncertainty" in achieving a particular result has been addressed or eliminated and that a particular result has been achieved, is insufficient to satisfy the "process of experimentation" requirement. The Department is unable to recognize the process of recognizing the uncertainties Taxpayer faces in the development of its metal products as sufficient under Indiana law to meet the regulatory and statutory credit requirements.

Setting aside issues related to whether the company was engaged in qualified research, Taxpayer disagrees with the audit's finding that Taxpayer failed to adequately document the company's employees' specific activities and wages attributable to those projects. Taxpayer admitted that the company did not maintain a system of contemporaneous project accounting in order to accurately quantify the company's research expenses. Instead Taxpayer relies on summaries, interviews and estimates to substantiate the amount of qualified research activities the company incurred. While the Department recognizes Taxpayer's efforts to estimate the qualifying wages of its employees, the Department rejects Taxpayer's argument that the Department is precluded from requiring specific, contemporaneous documentation and that "documentation is not necessary to prove taxpayer engaged in a particular activity in the tax year(s) at issue." Instead, the Department finds the law on this issue clear.

Treas. Reg. § 1.41-4(d) (T.D. 8930) sets out the record keeping and documentation requirement for expenses related to the research credit:

No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer - (1) Prepares documentation *before or during the early stages of the research project*, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section, and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed (except under section 6501(c)(1), (2), or (3)) for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) Satisfies section 6001 and regulations there under.

(*Emphasis added*).

Indiana provides its own record keeping requirements.

Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks. IC § 6-8.1-5-4(a).

The Department rejects Taxpayer's argument that it is sufficient to produce documentation in a "sufficiently usable form" because the argument grossly oversimplifies the regulatory requirement. Of course, any documentation must be "usable" but it also must be "prepared before or during the early stages of the research project." Treas. Reg. § 1.41-4(d) (TD 8930). The documentation must be *both* "usable" and "contemporaneous."

It is Taxpayer's statutory obligation to maintain and produce to the Department contemporaneous records

sufficient to verify the credits which it claims pursuant to IC § 6-3.1-4-1 and IC § 6-8.1-5-4. This is especially true in the case of the RECs for which the I.R.C. imposes stringent and detailed parameters and which - if Taxpayer seeks to obtain the benefit of those credits - Taxpayer is required to meet. Treas. Reg. § 1.41-4(d) (TD 8930).

Indiana case law speaks to the issue of the documentation required to establish one's entitlement to credits such as that sought by Taxpayer. "[A]n income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992). Moreover, where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the **exact letter of the law.**" *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d at 100-01 (Ind. Ct. App. 1974 (**Emphasis added**)). Thus, every taxpayer's claim against any tax must be supported by records necessary to substantiate the claimed credits and those records are required to be "kept" "before or during the early stages of the research project.

In this case, Taxpayer asks that the Department broadly interpret the REC record keeping requirements to encompass - as stated in the audit report - employee questionnaires and interviews - when there is insufficient evidence that Taxpayer's efforts to monitor and control the quality of its products constitutes the "process of experimentation" and the process of "discover[ing] information which is technological in nature."

FINDING

Taxpayer's protest is respectfully denied.

July 9, 2019

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